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SUBJECT: HONDURAS BANKING REFORM: FINANCIAL SYSTEM LAW MOVES BANK SUPERVISION TOWARD GLOBAL STANDARDS

REF: A) 04 Tegucigalpa 2765

B) 04 Tegucigalpa 2826
C) 05 Tegucigalpa 8
D) 03 Tegucigalpa 2062
E) 04 Tegucigalpa 232

¶1. (U) SUMMARY: In September and October 2004, the GOH passed four banking reform laws aimed at strengthening the nation's financial system. This is the last in a series of four cables that analyze each of these laws, assess their impacts on the Honduran financial system, and outline challenges of implementation and additional needed reforms that remain. Previous cables analyzed the reforms of the deposit insurance agency (ref A), the Central Bank (ref B), and the Banking Commission (ref C); this cable focuses on the Financial System Law.

¶2. (U) The Financial System law (Decree No. 129-2004) delineates the responsibilities of the Banking Commission and the Central Bank to supervise and regulate the country's financial sector. The overriding objective of the law is to bring Honduran financial sector regulation into compliance with the internationally recognized Basel core principles for effective banking supervision. The law also strengthens the previously ineffective national credit bureau and imposes new restrictions on bank ownership and management. While the current leadership of the Banking Commission has the respect of both government officials and the private sector, full implementation of the new law will take time and will require additional training of Banking Commission officials. End summary.

Background: The Need for Reform

¶3. (SBU) As summarized in ref D, a 2003 joint IMF/World Bank "Financial System Stability Assessment" for Honduras concluded that the Honduran banking system is "highly fragile at a systemic level, impairing sustainable economic growth," and outlined several reforms needed to strengthen the system. These reforms were then incorporated into the Letter of Intent signed by the GOH and the IMF in February 2004 (ref E), which required the passage of four financial sector reform bills: the Deposit Insurance law; the Central Bank of Honduras law; the Banking Commission law; and a new Financial System law.

¶4. (SBU) Specifically, while the report acknowledged that financial system regulation and supervision had improved in recent years, it found that important areas remained weak and required urgent action; the first of the report's four key recommendations was in fact to "strengthen prudential supervision and regulations." Until 1995, the supervision of Honduran banks was the responsibility of the Central Bank. The Banking Commission was created in 1995, but the Central Bank continued to supervise the banking system until 1998, so the Commission has had only a limited number of years of experience in supervising the Honduran banking system. Furthermore, the Commission operated under a very restrictive legal framework, which allowed corrective actions in response to a crisis, but severely limited the Commission's ability to proactively manage risk and avert potential crises before they took place.

Changes in the New Law

¶5. (U) EconOff met on December 1 with Joaquin Alcerro, Chief Legal Advisor at the Banking Commission and on December 8 with Maria Lydia Solano, Executive Director of the Honduran Association of Banking and Insurance Organizations (AHIBA), the private sector banking association, to discuss the contents and implications of the new law.

¶6. (U) Of the four financial reform laws passed in

September, the Financial System law is by far the longest and most important. Unlike the other three laws, which simply listed amendments and additions to existing legislation, the Financial System law is an entirely new piece of legislation, as the changes envisioned were considered substantial enough that an entirely new legal framework was needed. As a result, this was the last and the most difficult law of the four for Congress to pass in September; Banking Commission President Ana Cristina Mejia de Pereira spent many days in Congress going through the law, article by article, and explaining its implications to the congressional committee responsible.
¶7. (SBU) The law was also developed in close consultation with the private sector, represented by AHIBA. Solano stated that she was very pleased with the co-operation between the Commission and the private sector as the law was being drafted. While certain aspects of the law met with resistance from some bankers (especially those in some of the older, family-run banks), Solano says that there is nothing in the law that the banking sector cannot accept and that bankers are generally very happy with the clarity that the law provides, unambiguously delineating the responsibilities of Banking Commission versus the responsibilities of the banks themselves. Solano also praised the new law for providing banks with sufficient time to adjust to the new, tighter regulatory structure. This had been a fear of some bankers, who had previously expressed concern that the IMF's recommendations for financial sector reform would be imposed in a sudden and severe way that would impose an unreasonable burden upon Honduran banks.

Preventative Medicine

¶8. (U) According to Alcerro of the Banking Commission, the single most important change created by the new law is the granting to the Banking Commission of wider legal authority to intervene in the affairs of troubled banks before they are at the point of collapse. Speaking to the press after the law was passed, Banking Commission President Mejia also emphasized this change, summing up the law's key function as "converting the Commission's role from one of curative supervision to one of preventative supervision."

¶9. (U) Previous legislation gave the Banking Commission virtually no authority to administer preventative medicine - that is, the Commission could intervene in a troubled bank only once the bank had reached a crisis point. The new law gives the Commission the legal authority to intervene much earlier, when the first signs of bank fragility appear, demanding complete information from the bank on its portfolio and imposing measures on the bank to minimize its risk. As a result, the Commission will be able to play a much more proactive role in investigating and maintaining the health of troubled financial institutions. Note that with this greater authority comes a greater responsibility for the Commission to act impartially and apolitically, since it now may impose stricter requirements upon some banks than upon others, at its discretion.

A More Effective Credit Bureau

¶10. (U) The law should also greatly increase the effectiveness of the national credit bureau. While a credit bureau already existed in Honduras, it was of very limited usefulness, as previous legislation required financial institutions to report information only on their debtors who owed at least 300,000 Lempiras (currently about $16,100). As a result, the information that the credit bureau could access was incomplete and gave only a partial picture to other financial institutions of the true risk involved in lending to certain individuals. The new legislation grants the credit bureau access to a bank's entire portfolio of loans.

¶11. (SBU) In addition, the new law explicitly resolves a conflict that had earlier hampered the functioning of the credit bureau. Previously, there had been some ambiguity in Honduran law concerning the responsibility of banks to report information to the regulating authorities and the duty of banks to keep customer information confidential. The Financial System law clarifies this ambiguity, explicitly stating that provision of information demanded by regulatory, judicial, or other legal authorities shall not be regarded as an improper divulgence of confidential information. (Note: The issue of bank secrecy is often raised in conjunction with security concerns, since wealthy Hondurans and their family members are often targets of kidnapping. While kidnapping has decreased in recent years, it is still a serious security concern on the part of wealthy Honduran families. Many people express doubt that customer information will truly remain confidential if all

such information is being reported to the credit bureau under the aegis of the Commission. End note.)

Bank Management and Conflict of Interest

¶12. (SBU) The law also includes completely new regulations on the permitted make-up and activities of a bank's board of directors. Under the new law, no one may serve on the board of more than one financial institution, no one with an outstanding non-performing loan may serve on a bank's board, and no more than one-third of a bank's board of directors may be immediate relatives of one another. An article entitled "conflict of interest" forbids a bank board member or his family members to be present at a bank meeting when a matter pertaining to their own economic interests is being discussed. (Note: To Post's knowledge, this is the first time that the phrase "conflict of interest" has ever appeared in a piece of Honduran legislation. End note.)

¶13. (SBU) These provisions, if properly enforced, aim at a key problem of the Honduran banking system, namely the close family nature of many Honduran banks, and related-party lending (the frequent granting of questionable loans to friends, family members, or business partners). However, some of these measures could well be watered down by weak regulations - an article addressing nepotism, for example, states only that the employment of relatives as "senior officials" of a bank will be subject to a policy that the Banking Commission has yet to establish.

Financial Crimes

¶14. (SBU) The first draft of the law that the Banking Commission sent to Congress included articles on financial crimes and the penalties for such crimes. However, at the time, certain Congressmen protested that financial crimes and their penalties should be described in the penal code, not in a law about the structure of the regulatory system. As a result, those articles were removed from the Financial System law and prepared as a separate reform to the Penal Code. This law was approved by Congress in December and will be discussed in more detail septel.

Implementation and Next Steps

¶15. (SBU) The Banking Commission is currently preparing the regulations for the new law, with assistance from consultants paid for by the World Bank and the IDB. However, the key question is whether or not the Banking Commission has the capacity to carry out the more wide-ranging and pro-active role established for it by the new law. After all, the World Bank and IMF declared bluntly in their 2003 assessment that "the Commission has limited capacity to supervise banks on an ongoing basis," and the new law only adds to the Commission's responsibilities, without granting it any increased budget or resources to meet these responsibilities.

¶16. (SBU) When asked about the Commission's capacity to implement the new law, Alcerro (the Commission's legal advisor) acknowledged the need for greater training and increased staff but placed greater emphasis on the danger that certain political interests will be opposed to the complete implementation of the law's provisions. The biggest problem of the Honduran banking system, according to Alcerro, is the granting of loans to related parties. Many political figures, including Congressmen, are also owners or board members of Honduran banks. Just as there was some resistance in Congress to the passage of the Financial System law, Alcerro predicts that this pressure will persist and manifest itself in a lack of co-operation on the part of some banks that, because of their involvement in loans to related parties, would not welcome closer investigation and supervision from an independent commission.

¶17. (SBU) EconOff also asked Solano of AHIBA her opinion of the Banking Commission's capacity to implement the new law and to bring Honduran bank regulation up to Basel Standards. Solano's answer focused almost entirely on the individuals involved. She stated that the banking sector has tremendous confidence in the current president of the Banking Commission, Ana Cristina Mejia de Pereira, for two reasons. First, Mejia is herself a former banker, so the private sector respects her as one of their own. Second, she is considered close to President Maduro and therefore, it is hoped, would have the political support required to take difficult actions if necessary. (Note: President Maduro is himself a former President of the Honduran Central Bank and, as a result, has a far better understanding of banking issues than the average Honduran politician. End note.)

However, Solano cautioned, if Mejia and the current team of Banking Commission leaders were replaced by a more political group, the private sector would be very concerned.

Comment: A Greatly-Improved System

¶18. (SBU) Comment: The new Financial System law, along with the other three financial sector reform laws passed at the same time, unquestionably represent a major improvement in the legal framework governing Honduras' historically-fragile financial sector. The thorough and far-reaching nature of these legal reforms testifies to the GOH's commitment to implement the IMF program and to its willingness to address long-standing structural impediments to economic growth, even at the risk of offending certain politically-influential individuals in the banking sector. The GOH now faces the task of full and effective implementation of this greatly-improved framework. While bringing the legal framework for financial sector oversight into compliance with international standards on paper is a significant achievement, conducting financial supervision in a manner consistent with these standards in practice is a much more difficult process. End comment.

Palmer